Debt and Taxes

Lectures in Macroeconomics—Charles W. Upton

Does Deficit Financing Make a Difference?

• The Government is going to spend $100 on a one time project
  – Plan A is to hit people with a $100 tax bill so the government runs on a pay-as-you-go basis.
  – Plan B is to borrow the money.

Does it make a difference?
  – Maybe
  – And Maybe Not

Let's first see the conventional wisdom and then see what really happens.

If the Government Borrows

• Our familiar demand and supply of loans graph, showing how interest rates and the balance on current account are determined.

If the Government Borrows

• If the government borrows, the demand for loans shifts to the right. Interest rates rise and the BCA becomes even more negative.
If the Government Taxes

- On the other hand, if the government taxes, no change in the demand for loans and no change in interest rates or the BCA.

So the Choice Is...

Debt and Taxes

If the Government Taxes

- Z declines by $100 and people reduce consumption by (say) $10.
- The private demand for loans rises by $90 = $100 - $10

Interest rates rise and the BCA becomes more negative

$90 = $100 - $10$

So the Choice Is...

Well, not exactly

Debt and Taxes

If the Government Borrows

- The government demand for loans surely rises by $100.
- But what happens to the private sector?
If the Government Borrows

- The government demand for loans surely rises by $100.
- But what happens to the private sector?

If taxpayers must pay the $100 back, then their wealth has declined by $100 and C will fall by $10.

In short the net demand for loans rises by $90 = $100 - $10.

If the Government Taxes

- The shift in the demand for loans is exactly the same. Interest rates rise and the BCA becomes even more negative.

And, the changes are exactly the same as when the government borrowed.

So the Choice Is…

Ricardian Equivalence: (after David Ricardo)

The real tax is the spending. When the tax is collected does not matter; deficit financing is no big deal.
End

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